Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

- Gilts made big losses as UK GDP growth in Q2 surprised on the upside.
- Bunds followed Gilts lower on a relatively quiet day for euro area economic data.
- The coming week will bring new UK data for inflation, jobs, pay and retail sales, as well as updates on euro area inflation, IP and trade.

Daily bond market movements

Bond	Yield	Change
BKO 3.1 09/25	3.023	+0.083
OBL 2.4 10/28	2.620	+0.085
DBR 2.6 08/33	2.616	+0.093
UKT 0⅝ 06/25	4.997	+0.128
UKT 1⅝ 10/28	4.520	+0.142
UKT 3¼ 01/33	4.523	+0.166

*Change from close as at 4:30pm BST.
Source: Bloomberg

UK

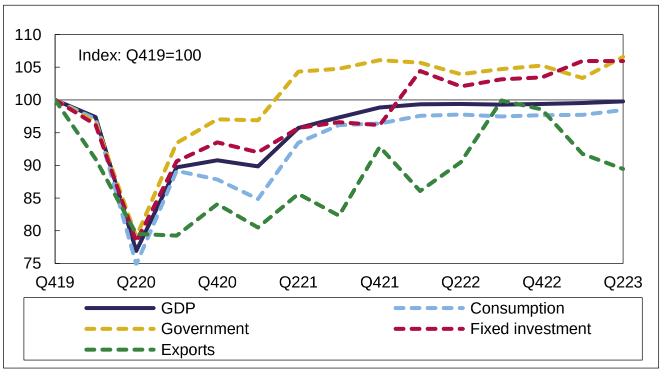
GDP beats expectations but remains below pre-pandemic level in Q2

UK GDP growth in Q2 beat expectations, rising 0.2%Q/Q and thus exceeding both the Bloomberg consensus (0.0%Q/Q) and the BoE's latest forecast (0.1%Q/Q). Growth was the strongest in five quarters and left GDP up 0.4%Y/Y suggestive of resilience in the face of the surge in inflation, which has been more acute than in other major economies. While it was a positive surprise, however, UK growth still lagged that of the euro area (0.3%Q/Q and 0.6%Y/Y) in Q2. And GDP was still some 0.25% below the pre-pandemic level in Q419 leaving the UK still as the only G7 country yet to pass that threshold. The upside surprise to GDP in Q2 reflected a stronger-than-expected rebound in economic output in June (an eight-month high of 0.5%M/M) following the dip in May related to the extra Bank Holiday for the King's Coronation, as warm weather gave an extra boost to consumer-facing services and construction. However, while the subsequent deterioration in the weather poses downside risks to growth in Q3, and survey indicators point to a significant recent weakening of momentum, the expenditure detail gives encouragement that positive GDP growth can be sustained over coming quarters even as the BoE's rate hikes are increasingly passed on to borrowers.

Growth led by consumption supported by welcome pickup in real wages

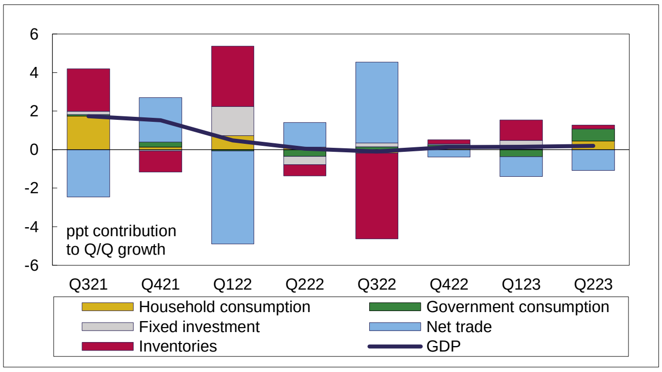
In terms of expenditure, household and government consumption drove growth in Q2, while fixed investment was flat and net trade subtracted significantly. Most striking was the leap in household consumption, with the pace of expansion at a five-quarter high of 0.7%Q/Q following zero growth the prior quarter. That splurge in spending was funded by a welcome pickup in real disposable incomes as wages and salaries rose by 2.6%Q/Q – reflecting the tightness of the labour market as well as a significant increase in the National Living Wage – which comfortably exceeded the 1.5%Q/Q increase in the consumption deflator as inflation started to slow. Growth in spending in consumer-facing services was particularly strong, including expenditure on transport (2.3%Q/Q), recreation and culture (1.4%Q/Q) and restaurants and hotels (1.1%Q/Q). But while spending on recreation and culture and hospitality is now well above the respective pre-pandemic levels, spending on transport remains more than 12% below that benchmark as working from home remains commonplace. And overall, household consumption in Q2 was still 1.2% below the pre-pandemic level. Meanwhile, having dropped 1.8%Q/Q in Q1 in part due to strike action in the public sector, government consumption in Q2 rebounded at a two-year high of 3.1%Q/Q due in no small part to higher pay in the National Health Service.

UK: GDP – selected expenditure components



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: GDP growth & contributions



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Business capex up thanks to spending on aircraft but exports remain exceptionally weak

The pause in fixed investment in Q2 followed strong growth in the category (2.4%Q/Q) in Q1 as firms brought forward spending to take advantage of the super-deduction tax allowance before it expired at the end of March. But while spending on ICT and other machinery and equipment fell almost 10%Q/Q, business fixed investment still rose more than 3%Q/Q for a second successive quarter to be 4.5% above the pre-pandemic level. That was thanks to increased spending on aircraft reflected in firm growth of 1.0%Q/Q of imports, which rose back above the Q419. In contrast, the volume of exports fell for a third successive quarter and by 2.5%Q/Q to be more than 10% below the pre-pandemic level. Overall, therefore, net trade subtracted 1.1ppts from GDP growth with inventories providing only modest offset. Nevertheless, with the terms of trade shock related to gas prices continuing to reverse, the value of imports fell more than that of exports. So, the total deficit in goods and services trade (excluding precious metals, which distort the underlying picture) maintained its downtrend, narrowing by a further £0.5bn in Q2 to £19.0bn, more than £11bn down from the peak five quarters earlier.

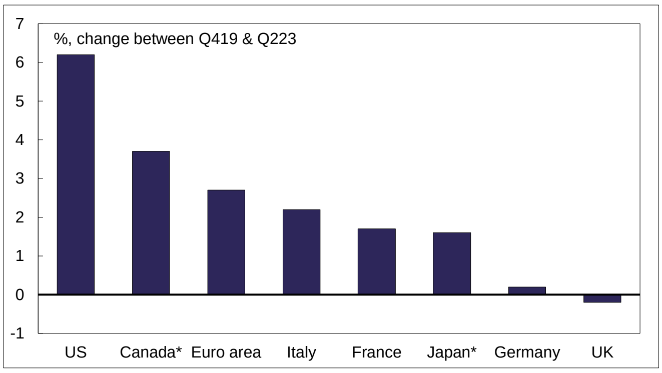
Manufacturing and construction drove growth in production in Q2

In terms of output, most major sectors posted positive growth in Q2. Despite a pickup in June, however, growth in services was modest at just 0.1%Q/Q to be still 0.9% below the Q419 level. Within that sector, hospitality rose 1.6%Q/Q with ICT services up 1.0%Q/Q. In marked contrast, other professional, scientific and technical activities contracted more than 1.0%Q/Q, while real estate and storage services contracted. Boosted by a sharp rebound in the auto sector (14.0%Q/Q) as supply chains were restored, and growth also in pharmaceuticals and metals among others, manufacturing output rose 1.6%Q/Q. That took it 6.0% above the pre-pandemic level even as autos production was still down some 19% against the same benchmark. Thanks to a strong June (1.6%M/M), construction output rose 0.3%Q/Q in Q2 to be 6.7% above the pre-pandemic benchmark. Once again, however, that reflected firm expansion in repair and maintenance activity while new work dropped. And mining and quarrying dropped for a fifth successive quarter due to declines in oil and gas extraction.

Moderate GDP growth likely to continue over the near term before higher rates bite more tightly

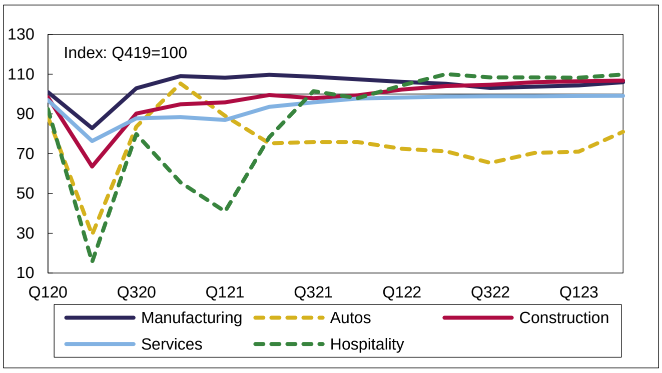
Survey indicators point to a weakening in UK economic activity at the start of Q3. For example, with services seemingly slowing and manufacturing reportedly contracting the most in six months, the composite output PMI fell more than 2pts in July to 50.7, also the lowest since January and a level consistent with a stagnant economy. While the construction PMI suggested that activity accelerated last month thanks to buoyant commercial and civil engineering activity, we think that inclement weather will have caused a setback. And the rain appears to have deterred spending on the high street too. So, we expect GDP to drop in July. Nevertheless, the reversal of the impact of the extra Bank Holiday in Q2 will provide a

G7: GDP compared to pre-pandemic level



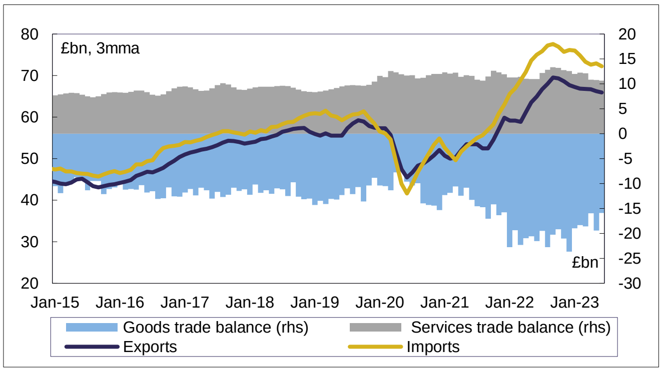
**Q123 latest data. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

UK: Services, manufacturing & construction output



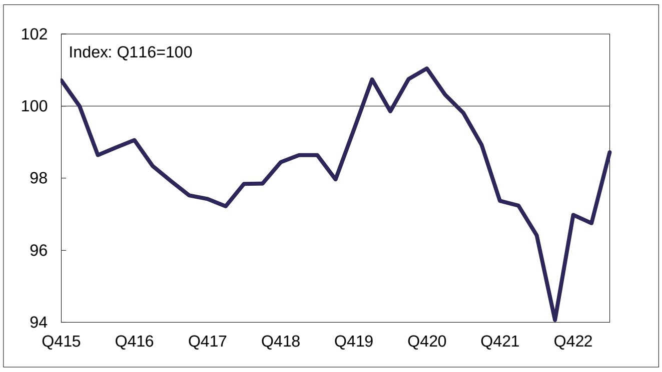
Source: *Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

UK: Trade balance



Source: ONS and Daiwa Capital Markets Europe Ltd.

UK: Terms of trade*



**Ratio of export to import prices. Source: ONS and Daiwa Capital Markets Europe Ltd.*

modest boost to production this quarter. More importantly, given strong pay growth, and with household energy prices cut in July and likely to be reduced again in October, positive real wage growth on an incremental basis should support household consumption over the remainder of Q3 and throughout Q4. So, we now expect GDP in Q3 to rise 0.3%Q/Q in Q3, just 0.1ppt softer than the BoE's forecast. Over coming quarters, however, an increasing share of households will face higher borrowing costs as they refinance their mortgages while unemployment will likely pick up gradually. And with higher interest rates also set to weigh further on investment, not least in construction, global demand for manufactured goods softening and scope for fiscal policy stimulus lacking, we expect GDP growth to slow into the new year. On balance, a broadly flat profile for GDP throughout 2024 looks more likely than outright recession. But should high inflation in services and/or elevated private sector pay growth persist, ongoing monetary tightening throughout Q4 would likely be forthcoming, with any contraction in GDP next year that results likely to be considered by the BoE as necessary to squeeze inflation out of the system.

The week ahead in the UK

While Monday will be quiet, the coming week will bring plenty more top-tier UK economic data, including the latest labour market report (Tuesday), July inflation figures (Wednesday), and July retail sales and August consumer confidence (Friday). Consistent with the softening in labour demand reported in recent surveys, we expect to see a significant slowing in employment growth, from 102k in the three months to May to below 50k, which would be the smallest quarterly increase since the three months to November. We also think that labour force participation continued to pick up, while – in line with the BoE's latest forecast – the unemployment rate in the three months to June was 4.0%, up 0.1ppt from the three months to March and 0.3ppt from the end of 2022. Nevertheless, while vacancies are likely to have slowed, wage pressures are likely to have remained strong. The BoE staff projected a negligible drop of 0.1ppt in private sector regular pay growth in the three months to June to 7.6%3M/Y, up 0.5ppt from the three months to March, and still well above levels that might be considered consistent with achievement of the Bank's inflation target over the medium term.

The July data, however, are highly likely to bring some better news with respect to inflation. That will be thanks not least to the drop in the Ofgem price cap, which means that from last month a "typical household" now pays an annual electricity and gas bill of about £2000 compared to £2500 from October to June. So, also given the slight further fall in petrol prices over the month, as well as the significant base effect, energy inflation looks set to fall more than 10ppts to below -7%Y/Y, the weakest since January 2021. With prices much better behaved, food inflation should fall for a third successive month. And given recent developments in producer prices, sterling stronger, and significant summer discounting as retailers sought to entice shoppers discouraged by inclement weather, non-energy goods inflation should slow significantly too. But the services component is currently most important for the BoE. And like us, reflecting recent evidence of persistence amid high labour cost growth, Bank staff expect services inflation to tick up in July, by 0.1ppt to 7.3%Y/Y. As such, while we (and the Bank) forecast headline inflation to drop 1.2ppts to a 17-month low of 6.8%Y/Y, we expect core inflation to edge down by just 0.1ppt, also to 6.8%Y/Y.

Finally, following three successive monthly increases, retail sales volumes always seemed likely to fall in July. And with surveys having reported that demand was particularly weak as wet weather hit footfall and deterred purchases of seasonal items, we expect a drop of between 0.5-1.0%M/M, the most since March. The deterioration in consumer confidence in July will not have encouraged spending either. And we expect no significant improvement to be reported in the August GfK survey on Friday.

Euro area

The week ahead in the euro area

The coming week will start slowly for euro area macroeconomic data, with no top-tier releases due Monday and the ZEW investor sentiment survey for August most notable on Tuesday. Like this week's Sentix indices, the ZEW survey might be expected to report a modest improvement in expectations with respect to the economic outlook thanks to lower inflation but a still-weak assessment of current conditions. Wednesday will be the busiest day for euro area data, bringing the region's industrial production data for June as well as updates on GDP and employment in Q2. While growth in IP (excluding construction) in May should be revised up slightly from the current estimate of 0.2%M/M, the figures released so far by the member states, including Germany and France, suggest that June will register a drop of between ½-1%M/M, which would leave it down around 1½%Q/Q in Q2. Indeed, the weak June IP data raise the possibility of a downwards revision to euro area Q2 GDP. However, for now, we think the second estimates will reaffirm the initial estimates of growth of 0.3%Q/Q and 0.6%Y/Y, which were boosted not least by renewed vigorous growth in Ireland-based multinationals and a surprisingly firm expansion in France. Meanwhile, the preliminary estimate of euro area employment in Q2, due the same day, should report a ninth successive quarter of job growth to a new high, albeit more moderate than the pace of 0.6%Q/Q, 1.6%Y/Y in Q1.

Meanwhile, at the back end of the week, the June goods trade report on Thursday will give an indication as to whether net trade made a positive contribution to euro area GDP growth in Q2. And Friday will bring the final estimates of euro area consumer price inflation in July as well as construction output figures for June. Today the estimate of French inflation on the EU-harmonised HICP measure was revised up by 0.1ppt to 5.1%Y/Y. But yesterday the equivalent Italian figure was revised down by the same margin to 6.3%Y/Y. And so, with the German (6.5%Y/Y) and Spanish (2.1%Y/Y) numbers unchanged from their respective flash estimates, we still expect the final euro area inflation data to align with the initial estimates. These showed that the headline inflation rate eased a further 0.2ppt in July to 5.3%Y/Y, the lowest rate since January 2022 and exactly half the peak recorded last October. But the improvement was principally due to food and energy components, and core inflation moved sideways, still nevertheless 0.2ppt lower than the series high reached in March. Finally, given marked declines of more than 2½%M/M in both Germany and France, euro area construction output appears to have declined sharply at the end of Q2, fully consistent with a sector that is facing a hit to demand in the face of concerted monetary tightening.

The next edition of the Euro wrap-up will be published on 15th August 2023

Daiwa economic forecasts

	2023				2024		2023	2024	2025
	Q1	Q2	Q3	Q4	Q1	Q2			
GDP								%, Y/Y	
Euro area	0.0	0.3	0.1	0.2	0.2	0.2	0.6	0.8	1.6
UK	0.1	0.2	0.3	0.2	0.1	0.0	0.5	0.5	0.7
Inflation, %, Y/Y									
Euro area									
Headline HICP	8.0	6.2	4.7	2.8	2.5	2.0	5.4	2.1	1.9
Core HICP	5.5	5.5	5.3	4.4	3.1	2.1	5.2	2.1	1.8
UK									
Headline CPI	10.2	8.4	6.8	4.8	4.5	2.9	7.5	3.2	1.8
Core CPI	6.1	6.9	6.6	6.1	5.6	3.7	6.4	3.6	1.7
Monetary policy, %									
ECB									
Refi Rate	3.50	4.00	4.50	4.50	4.50	4.50	4.50	4.00	3.00
Deposit Rate	3.00	3.50	4.00	4.00	4.00	4.00	4.00	3.50	2.50
BoE									
Bank Rate	4.25	5.00	5.50	5.75	5.75	5.75	5.75	5.25	3.25

Source: Bloomberg, ECB, BoE and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
France	Final HICP (CPI) Y/Y%	Jul	**5.1 (4.3)**	*5.0 (4.3)*	5.3 (4.5)	-
Italy	Trade balance €bn	Jun	**7.7**	-	4.7	4.8
Spain	Final HICP (CPI) Y/Y%	Jul	**2.1 (2.3)**	*2.1 (2.3)*	1.6 (1.9)	-
UK	GDP – 1st estimate Q/Q% (Y/Y%)	Q2	**0.2 (0.4)**	*0.0 (0.2)*	0.1 (0.2)	-
	Monthly GDP M/M%	Jun	**0.5**	0.2	-0.1	-
	Industrial production M/M% (Y/Y%)	Jun	**1.8 (0.7)**	0.2 (-1.1)	-0.6 (-2.3)	- (-2.1)
	Manufacturing production M/M% (Y/Y%)	Jun	**2.4 (3.1)**	0.2 (0.3)	-0.2 (-1.2)	-0.1 (-0.6)
	Services activity M/M% (Q/Q%)	Jun	**0.2 (0.1)**	0.2 (0.0)	0.0 (0.0)	-
	Construction output M/M% (Y/Y%)	Jun	**1.6 (4.6)**	0.0 (2.9)	-0.2 (0.2)	-0.3 (0.3)
	Trade (goods) balance £bn	Jun	**-4.8 (-1.5)**	-4.1 (-1.2)	-6.6 (-18.7)	-7.7 (-18.4)

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Italy	Final HICP (CPI) Y/Y%	Jul	**6.3 (5.9)**	*6.4 (6.0)*	6.7 (6.4)	-
UK	RICS house price balance %	Jul	**-53**	-51	-46	-48

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Wednesday's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
- Nothing to report -						

Auctions

Country	Auction
Germany	sold €4.04bn of 2.6% 2033 bonds at an average yield of 2.46%
UK	sold £3.5bn of 3.25% 2033 bonds at an average yield of 4.35%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's data calendar

The coming week's key data releases

Country		BST	Release	Period	Market consensus/ *Daiwa forecast/actual*	Previous
			Monday 14 August 2023			
			- Nothing scheduled -			
			Tuesday 15 August 2023			
Germany		10.00	ZEW current situation (expectations) balance	Aug	-63.5 (-15.5)	-59.5 (-14.7)
UK		07.00	Payrolled employees, monthly change '000s	Jul	-12	-9
		07.00	Unemployment claimant count rate % (change '000s)	Jul	-	4.0 (25.7)
		07.00	Average weekly earnings (excl. bonuses) 3M/Y%	Jun	7.4 (7.4)	6.9 (7.3)
		07.00	ILO unemployment rate 3M%	Jun	4.0	4.0
		07.00	Employment change 3M/3M '000s	Jun	97	102
			Wednesday 16 August 2023			
Euro area		10.00	GDP – second estimate Q/Q% (Y/Y%)	Q2	*0.3 (0.6)*	0.0 (1.1)
		10.00	Preliminary employment Q/Q% (Y/Y%)	Q2	-	0.6 (1.6)
		10.00	Industrial production M/M% (Y/Y%)	Jun	-0.1 (-4.2)	0.2 (-2.2)
UK		07.00	(Core) CPI Y/Y%	Jul	6.8 (6.8)	7.9 (6.9)
		07.00	PPI output (input) prices Y/Y%	Jul	-1.3 (-2.8)	0.1 (-2.7)
		09.30	House price index Y/Y%	Jun	-	1.9
			Thursday 17 August 2023			
Euro area		10.00	Trade balance €bn	Jun	-	-0.9
Spain		09.00	Trade balance €bn	Jun	-	-3.1
			Friday 18 August 2023			
Euro area		10.00	Final (core) CPI Y/Y%	Jul	5.5 (5.5)	6.1 (5.5)
		10.00	Construction output M/M% (Y/Y%)	Jun	-	0.2 (0.1)
UK		00.01	GfK consumer confidence	Aug	-29	-30
		07.00	Retail sales including auto fuel M/M% (Y/Y%)	Jul	-0.5 (-2.1)	0.7 (-1.0)
		07.00	Retail sales excluding auto fuel M/M% (Y/Y%)	Jul	-0.6 (-0.1)	0.8 (-0.9)

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's key events & auctions

Country		BST	Event / Auction
			Monday 14 August 2023
			- Nothing scheduled -
			Tuesday 15 August 2023
Germany		10.30	Auction: €5.5bn of 3.100% 2025 bonds
UK		10.00	Auction: £2.5bn of 1.125% 2039 bonds
			Wednesday 16 August 2023
Germany		10.30	Auction: €1.0bn of 0.00% 2050 bonds
		10.30	Auction: €1.5bn of 0.00% 2052 bonds
			Thursday 17 August 2023
France		09.50	Auction: 2.50% 2026 bonds
		09.50	Auction: 2.75% 2029 bonds
		09.50	Auction: 1.50% 2031 bonds
			Friday 18 August 2023
Euro area		11.00	ECB Chief Economist Lane scheduled to speak – 'The role of banks in fighting inflation'

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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